

FEDERAL COMMUNICATIONS COMMISSION

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In the Matter of:)	
)	
ROUND TABLE ON THE ECONOMICS OF)	
MERGERS BETWEEN LARGE ILECS)	Docket No. CC-98-141
HELD ON FEBRUARY 5, 1999)	
)	
LIVE VIDEOTAPE PROVIDED TO)	
HERITAGE REPORTING CORPORATION)	
ON FEBRUARY 8, 1999)	

LIVE TAPE

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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ON FEBRUARY 8, 1999)

Federal Communication
Commission
445 12th Street, S.W.
Washington, D.C.

Monday,
February 8, 1999

The parties met, pursuant to the notice.

BEFORE: WILLIAM ROGERSON

ATTENDEES:

WILLIAM ROGERSON, Chief Economist

DENNIS CARLTON
University of Chicago

ROBERT CRANDALL
Brookings Institute

JOSEPH FARRELL
University of California-Berkeley

ROBERT GERTNER
University of Chicago

RICHARD GILBERT
University of California-Berkeley

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ATTENDEES: (CONT'D)

ROBERT LITAN
Brookings Institute

ROGER NOLL
Stanford University

JEFFREY SHEPERD
University of Massachusetts

MICHAEL KATZ

HAROLD FURCHTGOTT-ROTH, Commissioner
Federal Communications Commission

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P R O C E E D I N G S

MR. ROGERSON: Good morning, and welcome to the FCC round table on the economics of mergers between large incumbent local exchange carriers.

In 1996 when the Telecom Act was passed, there were eight large regional telephone companies providing local telephone service, seven Baby Bells and GTE. Since this time the FCC has approved two mergers between these firms, reducing the numbers to six, and right now the FCC is faced with proposals for two more mergers that would further reduce the numbers down to four; specifically Bell Atlantic is proposing to merge with GTE, and SBC is proposing to merge with Ameritech.

Well, the two companies resulting from these mergers would control two-thirds of the local telephone lines in the United States. Furthermore, the arguments that proponents of these mergers are making to support them are the type of arguments that if the FCC accepted them might well also cause the FCC to accept further consolidation among the remaining four, perhaps to bring us down to two some people have suggested.

Therefore, I think that the FCC really is at a defining moment for telecommunications policy and that the decisions that the FCC is going to make about these mergers could well affect the structure of the telecom industry for

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years to come.

The issues that we have to evaluate, and I was actually getting very close to the climax here, Mike. I promised them all that you would show up at about this point.

The issues that the FCC has to evaluate really are very complicated, the FCC has discovered going through all of these. Critics of the mergers have told us at the start well, it is not all that complicated at all. You used to have eight, and you are on your way to two. That is on the face of it anti-competitive.

The proponents of the mergers have come back to us and told us well, these six current ILECs basically do not compete with each other at all. They are each in their own region and serving their own people, and there is very little competition between them. They have shown very little interest in competing out of region, and even when they have shown interests in competing out of region they have shown very little aptitude.

To the extent that there has been competition in local telephone markets, proponents of the mergers tell us that it has basically just been supplied by long distance companies trying to become local companies as well and by start up companies.

Proponents of the mergers have argued to us that

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most competition in local telephone markets is being provided by long distance companies and by independent start up companies. They argue that plenty of competition is being provided by these types of firms, and, in any event, whether Baby Bells merge or not is irrelevant to the issue of competition in local markets because they do not compete with each other.

In fact, they make a stronger argument than this. They claim that although these Baby Bells have been too small and anemic to compete out of region thus far, if only they were allowed to bulk up a little more, in fact, they might become very dynamic competitors out of region and actually increase competition if we allow these mergers.

Well, critics of the mergers do not take this lying down. They say yes, it is true that in fact the Bells may not compete with each other that much right now, but there is every indication that they would have begun to compete with each other tomorrow or six months from now or surely by next year.

The problem with these mergers, critics say, is not that they are going to destroy competition that is occurring today, but they are going to destroy competition that surely would have occurred but for these mergers.

Well, proponents come back and say this is highly speculative, and they do not think it is true. Then we will

see what the critics say to that. I think they say they think it is true. We will find out.

The issues do not stop here. It turns out there are a number of other distinct possible benefits and harms of these mergers that economists and other interested parties have raised. What I have tried to do today is to organize the round table that we are going to have into sessions that will kind of go systematically through the arguments that have been presented as the FCC sees them and expose each one to the full light of day and have some vigorous argument and debate about each of them.

We have a very distinguished panel of economists who are joining us today to help us go through these arguments, and I now would like to take a moment to introduce them.

I am Bill Rogerson, and I am the chief economist. Starting to my right is Dennis Carlton from the University of Chicago. He has submitted an affidavit on behalf of SBC-Ameritech in favor of the merger. Robert Crandall from the Brookings Institute submitted an affidavit on behalf of BA-GTE, and he was in favor of that merger.

Joe Farrell from UC-Berkeley submitted an affidavit on behalf of Sprint in opposition to the mergers. Rob Gertner from the University of Chicago submitted an affidavit on behalf of BA-GTE. Rich Gilbert from

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UC-Berkeley submitted an affidavit on behalf of SBC-Ameritech. Michael Katz from UC-Berkeley submitted an affidavit on behalf of Sprint.

Bob Litan from the Brookings Institute and Roger Noll from Stanford, these guys apparently could not find anyone to get them to pay them to write a paper, but they went ahead and wrote a paper anyhow, so they have published a Brookings research paper jointly co-authored that is critical of the mergers.

Finally, Jeff Sheperd from the University of Massachusetts has submitted an affidavit in support of a consumer group on behalf of a consumer group called the Texas Office of the Public Utility Council that is generally critical of the mergers.

The agenda for today. Do people have copies of it? Were they available? This has been a deep secret. None of our panelists do either. Apparently I can change this as I go along.

What the agenda in front of me says is we have divided the round table into four equally long sessions. Really what I have tried to do is focus on what seemed to be the four big issues that there has been a lot of debate about. We are going to consider them each one at a time.

The first issues are what are the potential benefits of these mergers, and how big are they? The

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second, third and fourth sessions are going to each focus on separate theories of harm the different parties have advanced that are critical of these mergers, so there are three quite distinct different theories of harms that have been put forward to the FCC that we have to evaluate and deal with.

Session Two will be devoted to the issue of whether or not these mergers will affect the FCC's ability to do benchmarking. Then we will have a break. Session Three will be devoted to whether or not these mergers will have effects on actual or potential competition.

Finally, Session Four will be devoted to whether or not these mergers will increase either the incentive or the ability of the large ILECs to act anti-competitively against their rivals. Then we will have a very brief concluding session where we can wrap up.

The way I am going to run each session is I have asked two to three people to each take five minutes at the start of each session to basically set out the framework of issues for us to give us a basic pro, what the argument is being made, and the basic con, what the structure on the other side is.

After we have had each of these people give us a basic framework for what the issue is, I am going to turn it loose to the entire panel, and I hope they will all question

each other vigorously and so on.

If they are not questioning each other vigorously enough, I am going to turn it loose to the audience. In fact, I am going to turn it loose to the audience even if you are questioning each other vigorously, so I should admit that now. Probably about five or ten minutes before the end of each session I am going to turn to the audience and ask the audience if they have any questions that they would like to address to our panelists.

Let's get started then. The first session is on potential benefits of the mergers. Do these mergers have benefits? If so, how big are they, and why do we know they exist? I have asked Dennis Carlton, Robert Gertner and Roger Noll to each make five minutes of opening remarks.

What I will do is when you have one minute left, Dennis, I will tell you you only have 30 seconds left, okay? Go ahead, Dennis, if you would like to start.

MR. CARLTON: Thank you. It is a pleasure to be here.

The merger of SBC and Ameritech will create a national competitor that can quickly provide a broad range of services for both residential and business customers. The benefits of stimulating competition in the provision of these services are undeniable and large. SBC plans to offer a wide variety of services, including local, long distance,

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Internet and customized data services for both residential and business customers in a one stop shopping environment.

The national/local plan is SBC's response to the rapid changes in demand and supply for telecommunications services. As far as I am aware, no one has seriously disputed that the national/local plan is a sound business strategy whose implementation will significantly increase competition.

The validity of the national/local plan is confirmed by the fact that the other major providers of telecommunications services are heading in precisely the same direction, the most prominent being the three major interexchange carriers, MCI WorldCom, AT&T and Sprint. It is no surprise that the objections to this transaction principally are being made by the very firms that SBC plans to challenge in the marketplace.

Opponents claim that the national/local plan should not be considered a merger specific efficiency. They have made two basic arguments which are glaringly inconsistent. On the one hand, they claim that SBC will not really carry out the plan. MCI WorldCom goes so far as to call the plan a rouse. On the other hand, opponents also claim that the plan is not merger specific because either SBC or Ameritech would carry out similar plans absent the merger.

Opponents are wrong. The claim that SBC's commitment is not credible can be easily dismissed. There is simply no reason to believe that SBC would willfully risk misrepresenting itself before consumers, investors, Congress and the FCC. Just yesterday on the front page of the Boston Globe there was an announcement of how SBC would offer new local service in Boston.

The claim that SBC or Ameritech would carry out the plan in the absence of the merger is simply unsupported speculation. The issue is not whether SBC could finance the plan by itself. The issue instead is whether in the absence of the merger SBC would have the necessary economic incentive to undertake such an aggressive plan in such a short time.

There is no evidence whatsoever to support the position that it would be profitable for SBC to undertake the national/local plan absent the merger. Acting alone, SBC would face higher costs and greater risk of failure in pursuing the national/local plan than under the merger.

For example, either firm would need to deploy more managers proportionately, more engineers. In the absence of the merger, they could not carry through with their follow to headquarters, follow to a home customer plan, as easily as they could after the merger. In the absence of the merger, the plan would be less attractive financially, and

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it would be perfectly rational for SBC or Ameritech to decide not to pursue this risky strategy.

Given the race now underway to offer packages of services on a nationwide basis, delays in establishing a national footprint translate into a reduced likelihood of a project success and, therefore, the reduced likelihood that a project of this scope and speed would be undertaken. The fact that mergers can create a national footprint should be no surprise. WorldCom's acquisition of MCI and AT&T's acquisition of TCG had similar motivations to accelerate the deployment of packages nationally of end to end service.

Furthermore, in addition to the national/local plan, the merger is expected to bring additional efficiencies. SBC expects to realize significant savings from the Ameritech transaction, including more than \$1 billion in annual cost savings by 2003.

SBC has a proven track record in achieving projected cost savings. In the Pac Tel merger, they are ahead of schedule in achieving more than \$1 billion in annual cost savings by the year 2000.

In sum, the substantial benefits from this merger are indisputable.

MR. ROGERSON: Dennis, you have 30 seconds.

MR. CARLTON: Okay.

MR. ROGERSON: I am not joking.

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MR. CARLTON: In sum, the substantial benefits from this merger are indisputable. The merger creates a more potent national service provider for business and residential customers. The notion that this merger should be stopped because someone hopes that each company would on its own embark on a similar plan is faulty. Consumers should not be deprived of the benefits of this transaction on the basis of unfounded speculation.

Thank you.

MR. ROGERSON: Thanks, Dennis.

Now Rob Gertner from the University of Chicago.

MR. GERTNER: Thank you, Bill, for the opportunity to participate in today's round table. I look forward to discussing the economic impact of these mergers. In my remarks, I will address the pro-competitive benefits of the mergers, focusing on the Bell Atlantic-GTE merger.

The telecommunications market is changing rapidly. Deregulation and new technology are transforming the industry. Not surprisingly, other industries facing such fundamental shifts have seen major changes in the identity, scope and scale of competitors.

These changes are characteristics of deregulated industries, such as airlines, trucking and energy, as well as technologically dynamic industries such as computer software and hardware and telecommunications equipment.

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Many of these changes include significant consolidation through mergers and acquisitions. Competitive adaptation to such a change in environment is fundamental for achieving economic efficiency. This is especially true in industries such as local telecommunications where the geographical and product scope of the companies has been determined by regulation rather than market forces.

Certainly proposed mergers must be analyzed carefully by regulatory authorities for potential anti-competitive effects, but regulators should be mindful of the value of competitive responses to a changing environment.

These mergers are between large companies. Although this may make some people worry, it is widely accepted that big is bad is a flawed way to think about mergers. Instead, we must evaluate carefully the likely impact of the mergers on competition and consumers.

Opponents of the mergers present a variety of objections to both proposed transactions, but their economic arguments lack empirical support. A careful analysis of the institutional and competitive environments in which these firms compete show that the opponents' concerns are not economically significant.

On the other hand, the pro-competitive strategic rationales for the mergers are strong. The most significant

benefit from the Bell Atlantic-GTE merger follows from two simple premises that are widely accepted by all parties, including regulators and companies opposing these mergers.

The first premise is that the ability to provide facilities based bundle services on a wide geographic scale is an important strategic asset for telecommunications providers. Indeed, the major opponents of these transactions are pursuing similar strategies in similar ways by acquiring firms that are allowing them to offer portfolios of telecommunications services on a national or near national basis.

For example, AT&T has recently completed several major acquisitions and announced a new business strategy based on offering bundled telecommunications services. The FCC, in proceedings on these mergers, has acknowledged the importance of bundle services, and the pleadings include statements from many business customers that they value such services.

The second premise is that existing customer relationships provide an important competitive advantage in the evolving market. Wide ranging evidence supports this view. The evidence includes the cost incurred by interexchange carriers and wireless carriers to induce customers to switch service, the difficulty GTE has had in selling services out of its local exchange region, consumer

surveys and the strategies adopted by numerous companies to sell new services to their existing customers or to make acquisitions to gain access to an expanded customer base.

The Commission also agrees with this premise. For example, in the Bell Atlantic-Ninex Order, the Commission argued that the major interexchange carriers are among the most important potential competitors in local markets because of their existing customer bases and brand recognition.

The merger of Bell Atlantic and GTE will have significant pro-competitive benefits. GTE's GNI and Internet backbone and Bell Atlantic's customer base are strongly complimentary assets. The combination of these two assets will create a strong facilities based bundle services competitor. Furthermore, the merged firm will use GTE's existing presence in or near many geographical dispersed markets to facilitate timely and efficient entry.

The benefits to consumers will include the presence of another national or near national provider of bundled telecommunications services. This increased competition should result in lower prices and greater consumer choice.

Businesses will be able to receive the same set of advanced services at all locations. They will be able to coordinate upgrades and service throughout their

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organizations with a single provider that understands their telecommunications needs. Consumers will be able to reduce transaction costs and coordination costs by having a single provider.

MR. ROGERSON: You have 30 seconds left, Rob.

MR. GERTNER: In addition to these benefits, the merger will result in significant cost savings. Bell Atlantic and GTE estimate that the merger will lead to \$2 billion annual cost savings within three years of the merger.

There is an important reason to not be skeptical about these benefits, given the experience that they have had in their previous mergers in meeting these targets. The pro-competitive benefits of the merger is clear. It would be unwise to forego these benefits because of potential harms that are unlikely and for which there is no empirical support.

Thank you.

MR. ROGERSON: Thanks, Rob.

Roger Noll from Stanford University.

MR. NOLL: I am still in awe of the new building. What did you guys have to do? Usually in the Silicon Valley when you walk into a new building like this you know that the company is successful and about to have an IPO, and can I buy stock.

I do not have a prepared statement because I did not have to clear it with any lawyers. That is actually one of the advantages of not coming here representing somebody. What I want to do is step back and say how should we think in general about merger policy in the context of the past 15 years of history in the telecommunications industry and then put these things in perspective, the arguments about benefits.

It seems to me that the entering premises here have to be two. The first premise has to be in the best of all possible worlds, if a firm believes it has a superior business strategy and wants to undertake a series of agglomerations, whether horizontal, vertical or adjacent, to achieve that business strategy we would normally just get out of the way and let them sink or swim on placing their own bets. That is the whole point of having a decentralized market based system.

Then we ask the question what is there about the history of telecommunications that might cause us to say this is not the right way necessarily to think about the problem? That is to say that we might want to look beyond the kinds of statements we have just heard about the largely firm specific benefits that would arise from this activity.

Now, of course, that is not necessarily bad because the premise is the first specific benefits arise

because they are somehow more able to please consumers. Therefore, they make more money by doing good, as well as by doing well.

The answer here is quite simple, and that is that we have a history of precisely these arguments defending the presence of ubiquitous monopoly in the industry not only in the U.S., but everywhere in the world.

That is to say that the history of this industry is one in which we have been told throughout the lives of everyone in this room that the nature of this industry is you are better off if there is just one guy out there who does everything, and you just sit back and do not worry your pretty little head about which particular alternative is offering better services, that it is just something that you should not worry about.

We know what you want, and it is to get the complete bundle of telecommunications services from a single ubiquitous provider, which is a different argument than the national monopoly argument. It is an argument about complexity, information impactedness and, on the supply side, the integratedness of the whole telecommunications enterprise.

We have a long history of looking back at things like the introduction of competition in the U.S. and other countries, things like the divestiture which created seven

RBOCs instead of one, all of which prior to the act being taken were predicted to impose substantial cost.

The flip side of the argument about benefits is that the introduction of competition and the introduction of divested RBOCs in multitudinous numbers was that there was going to be a big, positive cost impact. Indeed, the majority of state regulators at the time immediately following divestiture gave emergency rate relief to the RBOCs on the grounds that the act of undertaking divestiture was going to make them less efficient. These then emergency rate reliefs, within a matter of about 18 months, were all rescinded because they were unnecessary.

The is the first important background point. As a subsidiary of this, the only point that I think one needs to keep your eye on all throughout this argument --

MR. ROGERSON: Roger, in 30 seconds --

MR. NOLL: Right.

MR. ROGERSON: -- I am going to tell you that you have 30 seconds.

MR. NOLL: Okay.

MR. ROGERSON: I think you needed this extra warning.

MR. NOLL: Bill, I can still rescind that Ph.D.

Now that I thoroughly lost my train of thought, the right level of analysis is the industry, not the firm.

That is extremely important to bear in mind. The issue is what is happening to consumers in all markets, those who want to bundle their own packages, as well as those who get them by themselves.

What is happening to the cost of the firms that have not merged, as contrasted with the firms that have? We know that the long run cost trend in local carriers is in fact that real costs are declining. To say that the merged entities have had lower costs since the merger is not to say very much in an industry where costs are falling. I am not saying it is not true. I am just saying the right level of analysis is not the firm. It is the industry.

Finally, one more point before Bill gets here, which is think about this in the context of the Telecommunications Act. If it is the case that the vision of the Telecommunications Act of having ubiquitous, vertically integrated competition is true, then within a few years we are not going to care about these mergers. Within a few years, if these benefits are real, the companies that will succeed will be the vertically integrated ones, and we will not care if mergers take place.

If the vision of the Act is not true, then we are going to care a great deal if we in fact de facto recreate the old AT&T and undo all the competition and all the benefits from the competition that we have observed in the

last 15 years.

MR. ROGERSON: Thanks, Roger.

Okay, guys. Let me turn you loose. Rich, go ahead.

MR. GILBERT: I just want to respond to Roger, if I may.

This is not about creating a monopoly. This is about creating firms that can compete on a national and on a global scale with other integrated telecommunications providers, such as AT&T-TCI-Time Warner, Alliance and MCI and Sprint, and the global players as well, the French Telecom and British Telecom and NTT and such. This is the playing field that we are dealing with. This is not about creating a monopoly.

On the merger benefits side, I just want to focus on the in region benefits, since others have talked about the national/local strategy out of region benefits to say that this is not a speculative analysis. This is based on evidence, and the evidence is that we have a track record now from the acquisition of Pacific Telephone, Pacific Telesys, by SBC, and we have for this merger we have \$1.4 billion annually in projected cost savings.

At SBC-Pac Tel we had something similar, about \$2 billion, and the evidence right now is that those efficiencies are right on track. We have \$50 million in

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annual cost savings on tandem and trunk design. We have \$88 million in operator services, \$134 million in directory publishing. These are coming in proven, demonstrated efficiencies in region, so we do not have to speculate. This is fact.

MR. ROGERSON: Okay. Rich has said that if you have two comptrollers you can fire one, etc., and there is real efficiencies then to having two firms combine into one, right; just plain, old horizontal efficiencies because there are all sorts of things you do not have to do twice.

Is that true? Is there evidence to support it? Is that a significant reason for allowing this merger?

Bob?

MR. CRANDALL: I think I agree with Roger that you cannot find evidence of the technical economies of scale in something like that that would drive these mergers; that in fact there has to be something else.

I think what is driving it is a desire to reach out and become a national presence and compete against the Sprints and AT&Ts of this world, but we should not underestimate the impact of these mergers in creating efficiencies; that is, shaking out inefficiencies.

Right within this room there are people who have been estimating cost models that show that forward looking cost models give you much lower cost than the embedded costs

of these companies. There is a reason for that. These companies have been subject to numbing regulation for decades, and that is part of the problem.

In every industry that I know of that has gone through a major change of the increase in competition, whether it be from foreign trade or from deregulation, there has been a huge shake out of management. I remember in the airlines we had to retire Frank Bohrman to sell used cars in Arizona.

In the case of the steel industry, the only large steel companies that have survived and will survive are the ones who brought in new management. You need to shake up these organizations. You get enormous efficiency gains from doing it, and one of the ways you do it is through merger.

Even in this industry, AT&T has not really gotten its act together until it brought in a CEO from outside. I think you really need to allow these firms to sort things out. You need to allow these mergers in order to get these efficiencies. You have gotten a lot of them so far, and I think you can get a lot more.

MR. ROGERSON: Bob?

MR. LITAN: Is this on? Can people hear me? Yes? Okay. On efficiencies, and then I want to go back to potential competition in the national plan.

You can get a change in management without a

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merger, so I do not see how the merger is a condition for achieving these efficiencies. We will still have numbing state regulation even after these mergers if that is causing inefficiencies.

I am going to go back to the local plan and address several points that Dennis raised. First, he said that the firms I guess in the case of both of them, that they will both have enhanced incentives by merging the two of them to enter out of region. To me, that is not self-evident.

I would like to see that explained, especially in light of my second point, which is you would presume that those incentives were operational after SBC bought Pac Bell, and I did not see the combined SBC-Pac Bell running around with a national plan. Why is it that they need another RBOC to make the national plan a reality?

The third point that Dennis raised is well, why would SBC misrepresent itself about this plan? I do not think anyone has to accuse them of misrepresenting. The fact is that plans change all the time in this industry. AT&T rolled out a resale plan, only to basically rescind it and switch strategy to go to the cable strategy, realizing that resale at least was not going to work.

The point is that the FCC in advance has no way of knowing how credible any particular promise is. The promise

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may be credible at the time. It may be advanced in full faith, but it may change because business strategies change. After all, in the wake of these mergers SBC may say look, we want to spend all of our attention concentrating on in region, and we will get to outer region later. They could do that maybe four or five months after the merger, which leads to the final point, and that is I was trying to think creatively.

The FCC could take SBC at its word and say all right, if you are going to promise 30 new cities, we will make that a condition of the merger. All right. I mean, SBC in a way is taking an enormous risk by making this plan and inviting the FCC to attach this condition.

In my outline that I have handed out and I will address later, I point out that there are problems in imposing such a condition, and that is it is hard to operationalize. SBC could enter and then withdraw six months later and say well, we tried; it did not work, so there would be no way to enforce it.

Alternatively, you could impose a hold separate Order on the companies and then say well, you can basically merge after you go ahead and enter, but holding separate for several years may eliminate the efficiencies and probably eliminate the appetite of the management for doing the deal.

All of this is to say that the FCC should not

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dismiss, though, out of hand the notion that you attach this as a condition if in fact SBC is really serious about this, but I question the premise to begin with.

MR. CARLTON: May I respond?

MR. ROGERSON: Yes. Right. Jeff Sheperd wants to take a shot at you, too, but first I would like to have you specifically respond to the question why is it that SBC-Ameritech will have an increased incentive to enter and pursue a national strategy after this merger?

MR. CARLTON: Okay. I would like to actually respond also to something related that Roger said. I would like to make three points.

First, there is a distinction between ubiquitous monopoly and one stop shopping. If you have many people providing a bundle of products, you do not call that ubiquitous monopoly. I would call that competition among many people to provide a bundled product that is desirable, and that is what seems to be going on in people's pursuit of a national strategy.

Second, a merger like SBC's that is promising competition out of region strikes me as the antithesis of a merger creating a monopoly.

Now, to go directly to Bob's two points, what are the increased incentives --

MR. ROGERSON: Get to Bill's one question, too, at

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some point.

MR. CARLTON: Well, the first point was yours, Bill.

What are the increased incentives as a result of this merger? I think there are two or three points here. First, there is absolutely no evidence that absent the merger, either company on its own would undertake the same investments, the same project.

Now, what are the increased incentives? The national/local plan is based on the premise that following your customer gives you an advantage. What does following your customer mean? You have customers with headquarters in your territory. You have relations with them. You can then follow them. If you are merged, you have more customers in your territory that you can then follow. Therefore, you have more customer contacts. That is the first point.

It is a slightly different strategy than what the other say three large IXCs are following. It is a different strategy, and it would be materially affected if there were not a merger.

Second, and in fact I have a table in my report that shows precisely that if each company tried to do it on their own, say if Ameritech tried to expand into 15 extra cities, it would only cover what they believe is around 31 percent of their in region customers, while with a merger if

they could merge and then expand into the national/local plan they will cover 80 to 81 percent of the right coverage for their in region customers, which then makes it easy for them to expand out of region. That is the first point.

The second point. Why is it easier? If you look at what happens when a smaller company has to expand rapidly compared to a larger company, if you require a proportionately larger increase, which you would if SBC on its own had to undertake the same national/local strategy of going into 30 cities, that is a much larger proportional increase. You would have to expand more managers, more engineers. It is more costly.

We know adjustment costs rise with the speed of expansion. What does that mean? That means that the speed with which this strategy will be deployed is certainly going to be much slower if you require the companies to do it on their own.

What does a slower strategy mean in a race to capture customers with switching costs? It means the strategy will be likely less successful, so you have lowered the profitability of the strategy, and you have reduced the speed of the policy. Both of those are reasons why the incentive is greater and would bring benefit immediately to consumers.

This is precisely why you saw the large IXC's or

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one reason why you saw the large IXCs while they are involved in mergers and acquisitions in order to build up not de novo, but take existing assets, put them together quickly in order that they can get a national footprint.

You could have made the same argument with respect to those acquisitions. The point is when you start with an inefficient industrial structure dictated by regulation, not by marketplace efficiencies, you don't have the efficiently sized firms, and acquisitions can get you to that place quicker.

MR. ROGERSON: Okay. Wait one second. I just want to summarize in 30 seconds what I believe the answer was.

If SBC merges with Ameritech, the business plan for entering out of region will be more profitable than if SBC did it by itself.

Now the question I want to ask all of these panelists is will the business plan for SBC to enter out of region be profitable; maybe not as profitable, but still profitable?

MR. CARLTON: At the same speed? At the same speed?

MR. ROGERSON: Joe, go ahead.

MR. FARRELL: Good morning, everybody. We are present today at a historic occasion because --

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MR. ROGERSON: I think you are not answering my question, Joe.

MR. FARRELL: I am. I am. We are present at a historic occasion because Dennis has just revolutionized merger policy by giving arguments which prove very generally that creating larger firms always enhances competition because it is easier and more profitable for a larger firm to expand and take more customers than it would be for the component smaller firms to do so. The argument seems to prove a bit too much.

Now, one way of thinking of all this is to step back and say what is the right geographic market definition for analyzing this kind of merger? Clearly I think as far as most customers numerically are concerned, the big issue, of course, is the last mile bottleneck, and that is an issue that is defined in the customer's own local market.

The claims about the national/local strategy and wanting to become a national, if not international, competitor are really a statement that it is important also, or perhaps even instead, to analyze a market for customers who have multiple locations and so the question then becomes phrased in that way, and this is just a rephrasing, but I hope it is a useful one.

If you take that seriously, and obviously you have to also remember the other customers, but if you take that

seriously should we say because the geographic market scope is now national, if not international, rather than local, should we say that means that it is tremendously important to allow this company or this pair of companies to become better at serving that market? Obviously, yes.

Should we say, on the other hand, that it is really important not to allow all of the potential entrants into that national market because there is nobody serving that national market yet, to remain potential entrants into it?

We have a situation where there are zero companies currently who are in this alleged geographic market. You have a number of potential entrants, namely those who are in the smaller geographic markets and could expand. The question is how do you think about a merger as a step towards having somebody in that market, which at the same time reduces the number of firms that could come into that market?

MR. SHEPERD: Since I was promised or mentioned at some point --

MR. ROGERSON: Right. Okay. Go ahead.

MR. SHEPERD: I am Jeffrey Sheperd. I am much the oldest person on this panel. I have seen regulation working for so many decades.

I would like to speak as a colleague, not as

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another advocate among this group. The economists use usually much the same logic, all of us. It is just the judgements of amounts that differ more or less. That is why we get into these traps of advocacy arguments, speculation against speculation. I would like to suggest instead that we think of a different concept or, as Roger suggests, get a bigger perspective on these issues.

The points I would like to stress at this point are two. One, the sector is in a very unstable period right now, and companies rightly have a sense of risk that they are about to be blindsided by somebody else's merger if they do not do theirs. That is really the FCC's economic problem. They are facing a cascade of mergers, some of which I think are plainly irrational, but driven by fear, driven in an arms race.

There is actually a literature on arms races which would help understand why we are here and why, as you say, this is a critical moment. If the FCC draws the line now and says let's hold back, we will not let anybody merge at least if they dominate their markets for awhile until competition is established on the strength of these powerful companies, then, as has been said, it will not matter once competition is going, mergers. We can let them rip.

I am afraid if we spend instead the time today debating this specific merger or any of them, of course we

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will match two sided speculation against each other, and we will not get anywhere. I think we all know most of the details of both of these plans. Instead, the FCC needs some more collegial economic guidance on how to sort things out.

MR. ROGERSON: Richard?

MR. GILBERT: My first suggestion is that we should put these things up if we do not want to speak.

(Laughter.)

MR. GILBERT: It would be more efficient. Just a standard of convention.

I actually just have a brief comment, which is on what happened after the SBC-Pac Tel, why, you know, did we not stay out of region entry there. The fact is that SBC did have a plan around that time, and their plan was to use the wireless platform of their out of region wireless services as a platform to enter into local service.

They tried that in Rochester, and it was extremely unprofitable. It did not work at all. I think you can see that that is a need for change, a need for revaluing how they are going to deal with a national entry strategy.

MR. LITAN: But does that not discount then any promises now?

MR. GILBERT: Well, it is true that there is change. Of course there is change, but --

MR. LITAN: It just says that the FCC should not

give a lot of weight to that.

MR. GILBERT: -- they tried it, and it did not work.

MR. LITAN: I mean, that point says if I was the FCC, I would not give a lot of weight to that.

MR. GILBERT: You have to evaluate each proposal. What it is saying is that what we thought might work, which would have been an easier strategy with need for less capital, less scale, did not work. You have to go to the next step.

MR. ROGERSON: Michael?

MR. KATZ: Now I feel like I should go out in the audience and do a bad TV talk show. Maybe that is what this is turning into. Jerry Springer will be for the afternoon session. We will get to see the real action.

I just want to comment on a few things that have been said before. When Bob Crandall talked about looking at the internal efficiencies or shaking out the inefficiencies, and he talked about shaking it up through merger as Bob Litan addressed, he also mentioned in passing saying that competition is a great way to shake things up, and I agree with that.

I think that experience in a variety of different industries shows that, which I think, though, is not something that argues in favor of these mergers, but it is a

source of concern. I would just note for now it is something we should come back to.

When we discuss the loss of benchmarks, I think the focus in that session will be on the loss of regulatory benchmarks, but there is also the loss of benchmarks, this is competitive benchmarks, used by industry. I think when we are going to talk about internal efficiencies we need to think about it there. Similarly, when we get to the session on the issue of local competition, we are going to have this same issue.

I do not want to go into it now. Some people have already started the later sessions. That is something that we need to note, and it is by no means clear that this is an argument in favor of the mergers. We will hear more about that later.

I want to build on something that Joe Farrell said about arguments in favor of these mergers being too strong. I think the question maybe to ask everybody, particularly the proponents, though, is do they advocate having a single ILEC for the country? Do they think it would be fine to put the Bell system back together, and we can debate the part about long distance, but at least at the local exchange level?

It seems to me there are two reasons to ask that question. One is I think it brings out the positions more

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sharply. Second, it may be a relevant question for the Commission. I think there is going to be the question of after these mergers, if they are allowed, then the next merger will come along, and the argument will certainly be made well, it is not that big a deal, given the mergers that have taken place.

In fact, if nothing else, they should break up the remaining ILECs into little pieces and just merge one little piece at a time, each one being not that big a deal. In the end, of course, it is going to be a huge deal. It seems to me that is something that needs to be thought about.

Finally, I just wanted to mention something else. Joe was talking about local markets and the focus on customers and to what extent there were national customers. I think it is important to recognize. He was talking about end user customers, but also what is going on is there are a lot of carriers that are customers.

We keep hearing about how Sprint and AT&T and MCI are the rivals of the ILECs that are proposing to merge, but, of course, the other thing that needs to be taken into account is they are big customers of them. They are quite concerned about buying access services at a national level.

Now, obviously they cannot do that from any one ILEC at this point, but there is a relevant national market there, or at least it is something that needs to be taken

into account at the national level, and that is true even if the individual customers are not national.

MR. ROGERSON: Okay. This is the moment we have all been waiting for. Questions from the audience? Would anyone from the audience like to ask any of our panelists a pointed, witty, thoughtful question? Okay. How about other questions?

I think there is someone at the back. Stan Newman from the FCC?

MR. NEWMAN: Yes. Could the panelists who are representing the merging companies explain how much cap X you plan to spend out of region and how many subscribers you think that cap X will capture for you?

MR. ROGERSON: Who would like to handle that? Okay. None of them will. Roger?

MR. CARLTON: Well, I can say that those figures are in the testimony, the exact numbers. The plans have been filed.

My understanding is the initial investment that they are talking about is something around in SBC's case something like \$3 billion plus all the expenditures on managers and engineers and the like, and also that does not include all the expenditures that have been made to date.

My understanding of the penetration they hope to achieve, which was your question, in those cities that they

are in, you know, they do have projections over time. The exact numbers I cannot recite off the top of my head. I think they are somewhere between penetration rates of ten and 15 percent in those cities.

MR. GILBERT: I mean, the numbers I have seen are \$23.5 billion in operating costs over ten years, I think \$2 billion in up front expenditures, 80 switches in 30 cities, not counting 14 foreign locations and 2,900 miles of fiber internally in the U.S.

MR. CRANDALL: Let me just make one point. We are here to discuss the economic issues in this case. We are not here with fiduciary responsibilities to the stockholders of these companies. Therefore, we do not know precisely what the capital expenditure plans would be, nor can we attest to them over a long period of time.

MR. ROGERSON: Okay. Are there more questions? Pat DeGrabi?

MR. DEGRABI: Thanks. Here is an economics question about the national/local strategy.

The theory of the national/local strategy is basically one of incumbency advantage. Following the customer out of region means because I serve the customer in region, say Dallas, I am more likely to serve them in Atlanta for whatever reason it is that you want to announce. The question here is how big is that incumbency advantage?